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E.O. 12958: N/A
TAGS: ECON ENRG EINV EPET EFIN PREL PGOV CH
SUBJECT: CHINA/ENERGY: SIGNIFICANT AND SURPRISING PRICE HIKES

REF: BEIJING 2331

SUMMARY

¶1. (SBU) In a surprise move that came late on June 19, China's National Development and Reform Commission (NDRC) announced significant energy price increases. Effective June 20, gasoline rose 16.7 percent, diesel 18.1 percent, and jet fuel 25.2 percent; effective July 1, electricity will rise an average of 4.7 percent, although household consumers, the agriculture sector, and areas struck by the Wenchuan Earthquake in Sichuan will be exempted. The change in energy prices was driven by shortages caused by refiners finding it unprofitable to place fuel on the market as a result of rising global oil prices. The move was unexpected given recent inflationary trends, remarks last week by a senior official that subsidized fuel prices were important for social stability, and reports from economists that emphasized China's ability to maintain subsidies given its strong fiscal position. The price increases could add a fraction of a point to the consumer price index (CPI), but if food price inflation continues to slow, the overall CPI may actually show a decline nonetheless. Higher fuel prices could drive up demand for imported oil in the short term as refiners supply more fuel to a market presently facing shortages. In the longer term, however, the movement away from subsidies should slow demand growth for finished fuel products, and it is this anticipated effect that led to global oil prices falling 3.5 percet in response to the pricing news from China. Customers at a local filling station told Embassy staff they believe price increases will change car buying and driving patterns. END SUMMARY

FIRST PRICE HIKE SINCE NOVEMBER

¶2. (SBU) The NDRC announced significant energy price increases in a surprise move late on June 19. Effective June 20, gasoline rose 16.7 percent, diesel 18.1 percent, and jet fuel 25.2 percent; effective July 1, electricity will rise an average of 4.7 percent, although household consumers, the agriculture sector, and areas struck by the Wenchuan Earthquake in Sichuan will be exempted. Natural gas prices were not raised, while coal prices were capped at their June 19 rates for the remainder of 2008. China's policy of moderately subsidizing gasoline and diesel has insulated the public here from global oil price increases since the last price hike, a 10 percent rise in November 2007 when oil was trading around USD 90/barrel.

¶3. (SBU) Although domestic shortages have led to mounting pressure to raise fuel prices, this week's adjustments were greater and came sooner than many economists expected. Less than two weeks ago, NDRC Vice Chairman and Head of the National Energy Bureau Zhang Guobao

was quoted by Xinhua stating that China's current finished oil prices are conducive to the country's social and economic stability and that raising fuel prices too quickly would have a significant impact on the domestic economy.

PRICING DECISION DRIVEN BY SHORTAGES

¶4. (SBU) The NDRC told media the increase came as a result of rising international oil prices that had led to refineries shutting down, creating lines at filling stations and even limits on purchases in some parts of the country. State-owned refiners Sinopec and Petrochina have over recent months faced massive losses on sales of gasoline and diesel at below-market prices. According to local media reports, in the first quarter of 2008, fiscal subsidies to Sinopec reached RMB 7.4 billion due to rising international oil prices. In April alone, Sinopec received fiscal subsidies of RMB 7.1 billion. Meanwhile, Sinopec reported that the subsidies were covering less than half of its total losses on refining operations. China, the world's second largest petroleum importer, brings in just over half of its needs, thus forcing its refiners into an unprofitable situation where they must pay global prices for a significant portion of the crude they process but then sell their output at capped rates (Note: Sinopec relies more on imports than Petrochina. End Note.) The result has been widespread spot shortages, particularly for diesel, impacting transport by truck.

MARKET IMPACT

¶5. (SBU) Global oil prices fell 3.5 percent following the pricing announcement, in anticipation that a movement away from subsidies

should slow demand growth for finished fuel products. Of note, NDRC Vice Chairman Zhang Guobao in recent weeks has dismissed the idea that rising demand in developing countries such as China and India is to blame for the surge of oil prices, arguing that investments by hedge funds and other speculators have played a key role in driving up prices. Independent Beijing-based economist Andy Xie supported this argument in a recent article in the economic journal, Caijing, in which he argued that unusual supply and demand dynamics, low U.S. interest rates, and speculative capital have come together to create today's oil price bubble.

SHORT-TERM: MORE IMPORTS, GRUMBLING

¶6. (SBU) The new pricing should be an incentive for greater refinery production and may, ironically, lead to greater imports as pent-up demand is satisfied, according to RBS Economist Ben Simpfendorfer. But it is unclear whether the price hikes are sufficient to bring independent refiners, which account for as much as 15 percent of domestic production capacity, back into the market. Whatever the case, Chinese consumers and even state-controlled media have over time demonstrated significant irritation with high fuel prices, and the grumbling is likely to continue.

¶7. (SBU) An LES employee queried customers at a Beijing Sinopec station near the Embassy on June 20. Asked about the government's decision, younger drivers reluctantly accepted the price increase, stating that they understood that the decision is a result of higher international oil prices. Older drivers said they were surprised by and unhappy about the price hikes, adding that the price increased too rapidly. Most drivers said that this week's price increases will make them more inclined to use public transit and will encourage consumers to purchase smaller, more fuel efficient vehicles. (Note: The persons queried were probably among Beijing's more affluent population. Emboffs have not yet been able to gauge reaction among the city's poorer residents. End note.)

LONGER-TERM: MORE RATIONAL ENERGY USE, MORE INFLATION

¶8. (SBU) One of China's top economic and environmental priorities in the 11th Five Year Plan is reducing energy intensity by 20 percent.

With car ownership exploding here, there have been widespread calls for subsidy reform to bring proper price signals to the market. Higher gas prices should have an impact. By contrast, the top short-term economic priority of the government is combating elevated inflation, running around 8 percent over recent months. Raising fuel prices could add to this figure but this may not be noticed if food prices -- the overwhelming cause of recent inflationary trends -- continue to stabilize. Gasoline makes up a small part of the basket of goods used to measure inflation so the impact of fuel price increases on CPI is expected to be relatively small. Goldman Sachs economist Hong Liang expects the direct impact on CPI to be around 0.13 percent, while UBS economist Wang Tao estimates the impact on CPI to be about .5 percent. Hong Liang notes that a more pronounced impact is likely to be seen in declined profitability of downstream industries. Nonetheless, the price increases and resultant increase in fuel and power supply to the market could improve prospects for industries that were previously threatened by the possibilities of oil product shortages and power outages.

MORE TO COME?

¶9. (SBU) RBS economist Ben Simpfendorfer estimates the new spread between locally capped priced and international market prices for refined fuels to be 37 percent. UBS economist Wang Tao estimates that China's new oil product prices would be at an import parity of about USD 90/bbl. This suggests that further hikes are likely, especially if international prices continue to rise. Of note, however, the Chinese Government's fiscal position remains strong, so it is capable of choosing the time and pace of any further price hikes. Morgan Stanley economist Qing Wang claims that China is well-positioned to maintain subsidies compared to its peers in the region due to its low government debt levels. With concerns about inflation and social stability still running strong, the Chinese Government will be inclined to carefully monitor public response to this week's price increases before making further adjustments.

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